

**IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMIERA BLUE CROSS AND ITS AFFILIATES**

Washington State Insurance Commissioner's Docket # G02-45

REPORT OF

Banc of America Securities LLC

SUPPLEMENT TO

**Opinions as to Market Acceptance and
Issues Related to the Proposed Conversion of
Premera Blue Cross**

March 5, 2004

CONFIDENTIAL and PROPRIETARY
NOT FOR PUBLIC DISCLOSURE



Supplement To

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Introduction

Banc of America Securities LLC (“BAS”) has been asked to serve as an expert witness in the proceeding addressing the proposed conversion of PREMERA, Premera Blue Cross, and certain of its affiliates (collectively, “Premera” or the “Company”) from a not-for-profit to a for-profit health insurance company followed by an IPO. In connection with this role, BAS has been asked by Premera to address specific questions related to a potential conversion and IPO. These questions are the following:

1. Is Premera’s strategy of converting and accessing the public equity market reasonable?
2. Will Premera be an attractive investment?
3. Will Premera’s proposed transaction structure and terms be acceptable to investors?
4. What effect will Premera’s issuance of new shares have on the Foundations?

BAS addressed these questions and submitted a report titled Opinions as to Market Acceptance and Issues Related to the Proposed Conversion of Premera Blue Cross (the “Initial Report”) to the Washington State Insurance Commissioner (the “State”) on November 11, 2003.

On February 5, 2004, Premera submitted an amended Form A statement (“Form A”) to address concerns raised by the State’s consultants in their initial reports and in subsequent discussions. The majority of these revisions were related to the structure and terms of the transaction documents, as well as amendments related to compensation, economic and tax issues. Premera has asked BAS to address how the amendments affect the conclusions of BAS’ Initial Report, if at all. BAS has also been asked to address specific issues raised in reports filed by the Blackstone Group and Cantilo & Bennett, L.L.P. on February 27, 2004 (the “State’s Consultants’ Reports”), relating to Premera’s proposed conversion and subsequent IPO.

Most of the revisions in the amended Form A more closely align the terms with the conversion documents used by WellChoice, Inc. in November 2002, and have little to no impact on BAS’ original analysis and conclusions. The transaction structure and terms as laid out in Question #3 were significantly changed. Accordingly, this analysis will focus on those changes and the effect they may or may not have on the conclusions of BAS’ Initial Report. The findings addressed in this report should be read in conjunction with BAS’ Initial Report.

Question # 1

Is Premera's strategy of converting and accessing the public equity market reasonable?

BAS' Initial Report concluded that Premera's goal to raise capital to increase its strategic flexibility and execute its strategic objectives is reasonable. Like other health insurance companies that have gone public, Premera's intent to use the capital for general corporate purposes, such as increasing capital reserves, investing in infrastructure or developing new products, is also reasonable. The Company's Risk Based Capital ("RBC") levels are among the lowest of the Blue Cross Blue Shield Association ("BCBS") licensees and, in certain downside and upside operating scenarios, are projected to fall below BCBS early warning requirements. In addition, Premera has nominal cash at the parent level. As a result, Premera lacks the strategic flexibility required to achieve its full growth potential or to protect it in an operating downturn.

In order to achieve strategic flexibility, it is reasonable for Premera to access the capital markets. Completing an IPO is the most effective way in which Premera is likely to be able to raise a material amount of additional capital without either adversely impacting its RBC, or, if deemed appropriate by its Board, exploring a strategic partnership.

The Company's desire to increase strategic flexibility still exists and is still reasonable in BAS' view. Furthermore, Premera's stated use of capital has not changed with the amended Form A and remains reasonable. Given these opinions, BAS' Initial Report conclusion that "it is reasonable for Premera to take advantage of its current financial position to access the public equity market to increase its strategic flexibility and execute its strategic objectives" remains unchanged.

For further analysis of this question, please refer to BAS' Initial Report.

Question # 2

Will Premera be an attractive investment?

BAS' Initial Report discussed that investors will be more likely to invest in a company if its investment rationale is compelling and its key financial metrics fall within accepted ranges. Premera's IPO investment rationale is comparable to other successful health insurance IPOs, and its financial metrics fall within or near the range of nine recent health insurance IPO transactions. Based on these comparisons, Premera's IPO could be viewed as an attractive investment, taking into account past trends and current market conditions.

Premera's amended Form A does not alter the Company's ability to attain financial targets or projections relative to the originally filed Form A. Premera agreed to a number of two-year post-conversion economic assurances specific to the Washington market, as set forth in Exhibit E-8 of the amended Form A. With respect to these types of assurances, investors will want certainty that those economic assurance do not negatively impact the company from a financial or competitive standpoint. Premera management does not believe that these economic assurances will impair its ability to achieve its financial projections as laid out in the original Form A filing. Thus, BAS' Initial Report conclusion that "Premera's rationale and metrics should satisfy investor expectations, taking into account past trends and current market conditions, and therefore, Premera could be viewed as an attractive investment" remains unchanged. However, BAS believes that a material extension of these economic assurances could place Premera at a disadvantage to its competitors. This may cause concern among investors which could have a negative impact on the value of the Company.

For further analysis of this question, please refer to BAS' Initial Report.

Question # 3

Will Premera's proposed transaction structure and terms be accepted by investors?

BAS' Initial Report concluded that the transaction structure and terms proposed by Premera were similar to previous successful IPOs of converted not-for-profit BCBS licensees and were likely to be acceptable to the investment community, taking into account past trends and current market conditions.

The changes Premera has made to its transaction structure and terms as described in its amended Form A do not materially change BAS' analysis or conclusions. This is because most changes more closely align Premera's transaction structure and terms with those of WellChoice, the most recent health insurance company to convert to a for-profit company and successfully complete an IPO. These changes also reflect Premera's attempt to remain in compliance with BCBS licensing requirements. As discussed in BAS' Initial Report, and the State's Consultants' Reports, the loss of the Blue mark could impair the value of the Company.

The categories below highlight the most significant changes in Premera's amended Form A, as well as certain areas that were addressed in the State's Consultants' Reports.

Amended Foundation Structure

The amended Form A now proposes that Premera establish two Foundations: one for the State of Washington, and the other for the State of Alaska. The Voting Trust and Divestiture Agreements in the amended Form A consider both Foundations in aggregate with regards to the divestiture schedule. Therefore, the fact that two Foundations may be established to manage each State's stock entitlement, with each Foundation being given a proportion of the stock, is not fundamentally different in the eyes of an investor. Under this scenario, and assuming that both Foundations are coordinated in the divestiture process, the establishment of two Foundations should have little to no impact on the investment community and Premera's stock performance as a public company relative to one foundation.

Voting Trust and Divestiture Agreements

The Voting Trust and Divestiture Agreement is in place to help align the Foundations' monetization strategy with the interests of the investment community. The Foundations' motives and goals may not be completely aligned with the best interests of the Company or the investment community. The Foundations are motivated to liquidate shares to create the most value possible in the sale, whereas Premera and the public shareholders are motivated to drive long-term shareholder value. Similarly, a Foundation given complete voting control could elect a Board of Directors that serves the Foundations' charitable interests, but may not be ideally suited to run a public health insurance company. For these and other reasons, it is essential to have Voting Trust and Divestiture Agreements in place to protect Premera and its public shareholders during the transitional period when the Foundations are significant owners of Premera stock.

Many of the terms in the Voting Trust and Divestiture Agreement are included to ensure that Premera remains in compliance with BCBS licensure requirements. If Premera is deemed out of compliance with the BCBS it could lose its license to use the Blue mark. The State's Consultants have proposed that if Premera were to lose its Blue license, the Voting Trust and

Divestiture Agreements should be eliminated. While the loss of the Blue marks could in itself cause a decline in the value of Premera, the elimination of the Voting Trust and Divestiture Agreements could have additional negative impact on investor sentiment, as the protection provided to the public shareholders by the Voting Trust and Divestiture Agreements would be lost.

Size of Free Voting Stakes

The amended Form A provides that both Foundations each hold a 5% (less one share) stake outside of the Voting Trust, conditioned on BCBS approval. According to Premera management, the BCBS has indicated it will likely not support both Foundations each holding a 5% (less one share) stake outside of the Voting Trust. The State's Consultants have cited WellChoice as an example in which the BCBS allowed two entities to each hold 5% stakes outside of the voting trust requirements, one to the New York Public Asset Fund (NYPAF) and one to the New York Charitable Asset Foundation (NYCAF). However, while these two transactions' terms are similar, they are not identical. The NYCAF never held more than 5% of WellChoice's outstanding shares and therefore was never in violation of the BCBS ownership limitations and thus never required a waiver from the BCBS. In the case of Premera's conversion, both Foundations would require a BCBS waiver from compliance with the BCBS ownership limitations.

In amending the Form A, Premera's primary concern was to remain in compliance with the BCBS licensure regulations. As mentioned previously, violating BCBS licensing provisions could result in the loss of the Blue mark. This could be detrimental to the value of Premera, could adversely impact Premera's stock price and may result in a diminution of the value of the Foundations' shares. In contrast, the advantages gained by the Foundations from holding these additional shares outside of the Voting Trust are very modest, at best, relative to the attendant risk of losing the BCBS license.

Voting Rights

The changes made in Premera's amended Form A more closely align the voting rights structure on particular matters to that of WellChoice, the most recent conversion candidate to successfully undergo the conversion process. Table 3.1 below highlights the terms of the voting rights set forth in Premera's amended Form A and compares them to the corresponding terms found in WellChoice's Form A.

TABLE 3.1. Summary of Voting Rights

Premera	WellChoice
Trustee shall vote Foundations' shares in favor of each nominee of the Board of Directors whose nomination has been approved by independent Board majority	Identical terms
Trustee shall vote Foundations' shares against removal of any director unless approved by an independent Board majority	Identical terms
If the matter is an employee compensation plan or a precatory stockholder proposal the Trustee shall vote all Capital Stock in the same proportions as the shares voted by all holders of Capital Stock other than shares held by the Voting Trust, Beneficiary, Foundation, directors, officers, trustees of any employee benefit plans of the Company and other affiliates of the Company	Identical terms
If the matter is an approved change of control proposal, a subsequent amendment to the initial equity incentive plan or any new stock-based program that would be effective during the stock registration period, the Trustee shall vote all Capital Stock held by the Voting Trust as directed by the beneficiary	Same as to change of control proposal only
If the matter is not specifically covered in the Voting Trust and Divestiture Agreement, the Trustee shall vote in accordance with the recommendation of the independent board majority	Identical terms

The voting rights provided in the amended Form A filings of both Premera and WellChoice are nearly identical and should not be viewed negatively by the investment community.

The State's Consultants' Reports suggested that a free vote should apply to all transactions resulting in a change of control of more than 19.9%. Premera's amended Form A, which is similar to the terms of WellChoice's filings and in compliance with the BCBS licensure regulations, calls for a free vote of all Foundation shares held in the Voting Trust in a transaction resulting in a change in ownership of more than 49.9%. A change in control typically does not occur until there is a 50% or greater change in ownership and the State's Consultants' 20% proposal is more aggressive than the WellChoice precedent. Given that Premera's change-in-control provision is similar to that in WellChoice's conversion, it should be more in line with previous investor experience.

Divestiture Schedule

The divestiture schedule is important because it sets a schedule for the orderly liquidation of shares held by the Foundations. Investors understand that the Foundations will divest their positions over time and they want the distribution to occur in an orderly fashion so that sudden selling pressures do not depress the value of the shares. Investors have become comfortable with the BCBS conversion process, particularly as it relates to the liquidation of large shareholder positions. For example, the distribution of Foundation Shareholder shares in the case of WellPoint was very successful and well received by investors, as seen in BAS' Initial Report.

Premera's amended Form A contains other changes to more closely align it with the WellChoice model. Table 3.2 compares Premera's original Form A, Premera's amended Form A and WellChoice's divestiture schedules.

TABLE 3.2. Comparison of Divestiture Schedules

Period	Premera Original Form A	Premera Amended Form A	WellChoice
1 year	80%	80%	NA
3 years	50%	50%	50%
5 years	5% ⁽¹⁾	20%	20%
10 years	NA	5%	5%

(1) Must reach 5% in 6 years.

As shown above, Premera's amended Form A divestiture schedule is consistent with the WellChoice model, and should therefore be acceptable to the investment community. The only difference in the divestiture schedules is that Premera requires the Foundations to reduce their combined holdings to less than 80% of the common stock outstanding within one year of the IPO. This part of the divestiture schedule was raised as a concern by the State's Consultants. However, the State's Consultants also suggested that the IPO should result in at least a 20% float post-IPO. If this proposal were implemented, the Foundations would be reducing (either through liquidation or dilution) 20% of their holdings at the time of the IPO, thus achieving the required reduction of the Foundations' stake automatically.

The amended Form A recognizes that the BCBS requires both Foundations' divestiture schedules to be consolidated to ensure the rational divestiture of shares. Furthermore,

Foundations formed in other BCBS not-for-profit to for-profit conversions have not had any known difficulties meeting their divestiture schedules. Given the success of these precedent transactions, it is unlikely that the Foundations in this transaction will experience difficulty meeting the divestiture guidelines.

In summary, the divestiture schedule is in line with the WellChoice model and conforms to BCBS regulations. Furthermore, its current form will promote an organized and rational divestiture of shares and therefore will likely be acceptable to investors.

Board Members

Premera's proposed structure allots one board member for both Foundations. This structure, as well as the nomination procedures and term of the board member's service, are consistent with the WellChoice model. In addition, the investment community is familiar with foundations having one board seat. However, and probably most importantly, the BCBS' position has been to allow only one board member. The BCBS has indicated it is unlikely to move from this position. Again, the potential loss of the Blue marks would likely have adverse consequences to the value of the Company's stock.

Registration Rights Agreement

Within the Registration Rights Agreement, the Demand Registration Rights set forth the terms surrounding the Foundations' right to demand registration of their securities. In the original Form A, Premera's Demand Registration Rights were similar to those contained in the RightCHOICE and WellPoint conversions, as the Foundation could demand registration rights at any time until all stock was sold. The demand registration rights in the amended Form A are now similar to those contained in the WellChoice conversion.

The State's Consultants have argued that Premera should bear total responsibility for registration expenses. The current provisions in the amended Form A are consistent with previous conversions and therefore will not likely have an impact on investor sentiment. The investment community will be more focused on the establishment of an adequate divestiture schedule that outlines the sale of shares in a rational manner and the Foundations' ability to meet the terms of that schedule.

Unallocated Shares Escrow Agent Agreement ("Escrow Agreement")

In its amended Form A, Premera included an Escrow Agreement so as to ensure it could close its IPO even if the States of Washington and Alaska are unable to agree on an allocation of the new Premera shares. An escrow account serves as an appropriate legal measure to ensure that no party receives the shares until an agreement on the proper allocation of shares is met. The creation of an escrow account is unlikely to affect investor perception of Premera as an investment opportunity. The investment community is likely to be more concerned about the divestiture and orderly liquidation of shares. That the shares may remain in an escrow until an agreement on share allocation is reached should have little to no effect on investor sentiment. Finally, this Escrow Agreement is similar in nature to that of WellChoice. Investors are experienced with the escrow provision as seen in WellChoice's conversion processes and are unlikely to view it negatively.

IPO Transaction Terms and Timing

The State's Consultants have requested that Premera provide specific details for the proposed IPO. Given the uncertainty of market conditions at any future time, it is unreasonable to assume that Premera would commit to any specific terms before having a better understanding of the market conditions at a time closer to the IPO. It is reasonable, however, for Premera management to provide preliminary guidelines for the amount of capital to be raised in an IPO, with the caveat that the estimates could change due to several factors such as changes in the Company's capital needs or changes in market conditions.

Furthermore, the State's need for information regarding the specific IPO terms will be met through the preparation of a Procedures Opinion by the State's investment banking Consultants and by the Premera Board Member's (appointed via the Foundations) participation on the IPO pricing committee.

Option Grant Waiting Provision

Premera's amended Form A states that it must wait twelve months after the IPO before issuing option grants to certain executives. This waiting period is typical among converting not-for-profit BCBS companies. Most other companies have a management team with options and / or shares in the company at the time of the IPO, a condition seen by investors as aligning interests of management and shareholders. The longer the waiting period until management has such interest, the less aligned company management and employees may become with the performance of the company, and the more likely it becomes that investors may have concerns. Premera's current provision of twelve months is the same as that in the WellChoice transaction and should be acceptable to investors.

Conclusion

In summary, Premera's amended Form A is very similar to the WellChoice model and remains in compliance with BCBS licensure requirements. Therefore, it will likely be acceptable to the investment community, taking into account past trends and current market conditions. While this is the case, the State's Consultants' Reports suggest additional terms to increase the Foundations' flexibility. On the contrary, they could create the risk of negative impact to value, which could occur if the Blue marks were lost by virtue of these suggested changes.

Question # 4

What effect will Premera's issuance of new shares have on the Foundations ?

BAS' Initial Report concluded that "the impact to the Foundations from Premera issuing primary shares is determined by the long-term use of proceeds. If Premera utilizes these proceeds in a strategic manner to support growth, then raising primary capital in an IPO may increase value for the Foundations. Furthermore, it is possible for the Foundations to realize greater cash proceeds by allowing Premera to issue primary shares in the IPO and waiting to sell secondary shares in a follow-on offering."

Premera's amended Form A does not change or affect BAS' original analysis. BAS has concluded its response to Question #4 remains unchanged.

For further analysis of this question, please refer to BAS' Initial Report.

Conclusion

The amendments to the Form A as filed by Premera in response to the State's Consultants' Reports leave the conclusions from BAS' Initial Report virtually unchanged:

- Premera's strategy for pursuing a conversion and IPO at this time in order to increase its strategic flexibility remains reasonable.
- The Company is still positioned to be an attractive investment.
- Premera's proposed transaction structure and terms are closely aligned with WellChoice, which was the most recent BCBS conversion and IPO to be accepted by the investment community. The proposed structure is also in compliance with BCBS licensure requirements which is important to Premera's value as a Company. Accordingly, the transaction will likely be acceptable to the investment community, taking into account past trends and current market conditions.
- The ultimate impact to the Foundations from a primary offering of shares will be determined by Premera's ability to utilize the proceeds in a strategic manner and generate long-term value creation.

Finally, the State's Consultants' Supplemental Reports suggest additional terms to increase the Foundations' flexibility. These suggestions, if implemented, would not significantly enhance the value of the Company or Foundations' holdings. On the contrary they could create the risk of negative impact to value, which could occur if the Blue marks' were lost by virtue of these suggested changes.